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TREASURY FOR J. ROSE

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SUBJECT: TURKEY'S ISLAMIC BANKING SECTOR

¶1. Islamic banking in Turkey began in 1985 when the Ozal government authorized the creation of "special financial institutions" and Albaraka Turk, an offshoot of Al-Baraka Banking Group of Bahrain, opened as the first interest-free banking institution in Turkey. Interest-free banks in Turkey eschew the "Islamic" label and go by the euphemism "participation bank" (katilam bankasi). Four of the 51 commercial, participation and investment banks in Turkey are interest-free: Bank Asya, Turkiye Finans, Albaraka Turk and Kuveyt Turk. A fifth participation bank (Ihlas Finans) failed during the 2001 financial crisis due to poor management, primarily a failure to diversify risk adequately. Although some international banks with operations in Turkey (Citibank, HKSB) have Islamic banking operations in other countries, none market interest-free banking in Turkey.

¶2. Participation banks currently account for 4% of all deposits and 6% of all loans as well as 3% of the sector by asset value. Unal Kabaca, President of Asya Bank, noted the participation banks' share of total asset value has been steadily rising, moving from 2.8% in 2006 to 3.1% in the first half of 2007 with a projected 3.4% by end 2007. Kabaca argued that Bank Asya's focus on medium-sized companies and comprehensive marketing efforts would underpin expansion in the coming years. He claimed the sector still had room to expand and indicated the four banks hoped to reach a 10% share by asset value of the total industry by 2017. Adnan Buyukdeniz, General Manager of Albaraka Turk, agreed there was significant room for expansion noting that the participation banks' share of the deposit and credit markets was far below their potential.

¶3. According to Osman Akyuz Secretary General of the Turkish Participation Banks Union (TKBB), participation banks have a total of 419 branches throughout the country with just under 9,000 employees. Although Turkiye Finans is based in Kayseri and focuses its operations in that city and the surrounding provinces, the remaining three participation banks are not regionally focused. Bank Asya has 180 branches with 52 in Istanbul, 9 in Ankara, 6 in Izmir, 4 in Antalya and the remainder scattered more or less evenly throughout the country. Albaraka's 60 branches are also distributed throughout the country.

¶4. Turkey's participation banks tend to focus on commercial/corporate lending rather than retail loans. Short term inventory financing, letters of credit, financial leasing, bid bonds and performance bonds as well as cash management services are market niches where interest-free banks have demonstrated an ability to compete without needing to collect or pay interest. Kabaca explained that Bank Asya's construction finance business was based on commission income with the bank charging commissions on bid and performance bonds. Bank Asya also provides cash management

services including payroll, purchasing, and subcontractor payment that encourage intra-network linkages thereby increasing Bank Asya's customer base. Financial leasing (full payout leases) comprises 20% of Albaraka's credit portfolio and enable customers to finance in-kind rather than in cash. Under this system Albaraka purchases a good (generally machinery or equipment) and leases it to the customer for a defined multi-year period. At the end of the term of the lease the title is transferred to the lessee.

¶5. Charge cards as well as mortgage lending and auto finance are the retail banking areas in which participation banks see the most opportunity for expansion. Kabaca cast providing charge card services as a social responsibility which happens to be profitable. "Asya card" currently has a 1% share of the credit card market with 600,000 card holders and a target of 1 million card holders. It is a charge (not debit or credit) card that does not permit cash withdrawals. Payment is due in full at the end of each month. Although late payments are assessed a fee equal to 4% of the overdue amount, compound interest is not charged on overdue amounts. Mortgage loans are normally structured as installment payment plans with the customer holding the title and the bank placing a lien on the property. Down payments in the region of 20-30% are required and the term of the loan ranges from 36 to 60 months.

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